SEC ADOPTS LARGE TRADER REPORTING SYSTEM

The SEC has adopted Rule 13h-1 under Section 13(h) of the Securities Exchange Act of 1934 (the “Exchange Act”) to establish a large trader reporting system. Under this system, broker-dealers maintaining securities accounts for “large traders,” as that term is defined under Rule 13h-1 (the “Rule”), will be required to report specified information to the U.S. Securities and Exchange Commission (“SEC”), upon the SEC’s request, about transactions in NMS securities (as discussed below) effected through those accounts. Any person or entity that exercises discretion over securities accounts and that engages in transactions in NMS securities at or above a specified dollar or share level will fall within the definition of large trader, irrespective of whether that person or entity is registered with the SEC. Private funds, family offices, registered investment companies, investment advisers, broker-dealers and individuals all could qualify as large traders, depending on how actively they trade in NMS securities.

The Rule:

- defines who is a large trader for purposes of the Rule;
- requires large traders to self-identify to the SEC and to obtain from the SEC a large trader identification number (“LTID”);
- requires large traders to provide the LTID to each U.S.-registered broker-dealer through which it effects transactions in NMS securities;
- requires U.S.-registered broker-dealers to provide to the SEC, upon request, data on large traders’ transactions in NMS securities by the morning after the transactions are effected; and
- requires U.S.-registered broker-dealers to maintain books and records, and perform certain monitoring functions, with respect to these transactions.

The SEC has also adopted Form 13H under Exchange Act Section 13(h). A large trader must submit to the SEC Form 13H as an “Initial Filing” to receive its LTID and file various periodic amendments thereafter. All Form 13H filings are confidential. Click here for a link to Form 13H.

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Effectiveness and Compliance Dates

The Rule becomes effective on October 3, 2011. Large traders have to identify themselves to the SEC starting on December 1, 2011. Broker-dealers have to maintain records, provide reports, and monitor large trader activity starting on April 30, 2012.

The SEC states that “[l]arge trader reporting requirements will provide the Commission with a valuable source of useful data that will greatly enhance the Commission’s ability to identify large market participants, and collect and analyze information on their trading activity.”

According to the SEC, its current system for collecting transaction data for regulatory and enforcement activities, the Electronic Blue Sheet (“EBS”), is of limited usefulness in reconstructing market activity. In the SEC’s view, EBS lacks two important data elements: time of execution for an order and a uniform identifier to identify the participant that effected the trade. EBS also does not require that transaction data be available on a next-day basis.

Some commenters on the proposed large trader reporting rule took the position that the system would be duplicative of the SEC’s proposed consolidated audit trail. The SEC, however, notes that the proposed consolidated audit trail is still under consideration and that it does not view large trader reporting to be duplicative of that proposal. Rather, large trader reporting is intended to “address the Commission’s near-term need for access to more information about large traders and their trading activities and to begin to improve the Commission’s ability to analyze such information.” By contrast, the consolidated audit trail would require the disclosure of “extensive information regarding orders, trades, and customers in a uniform manner across all markets and other execution venues.”

Definition of “Large Trader” and Basic Filing Requirements

The Rule defines a “large trader” as a person who (i) directly or indirectly, including through other controlled persons, exercises investment discretion, as discussed more fully below, over one or more accounts; (ii) effects such transactions for the purchase or sale of any “NMS security,” as defined under Regulation NMS of the Exchange Act, for or on behalf of such accounts by or through one or more registered broker-dealers; and (iii) effects such transactions in an aggregate amount equal to or greater than: (a) during a calendar day, either two million shares or shares with a fair market value of $20 million dollars; or (b) during a calendar month,
either 20 million shares or shares with a fair market value of $200 million (these thresholds are referred to as the “identifying activity level”). The Rule also permits a person to register voluntarily as a large trader by filing Form 13H.

The Rule requires a large trader to identify itself to the SEC by filing electronically Form 13H promptly after first effecting aggregate transactions equal to or greater than the identifying activity level.\(^8\) Form 13H is discussed in greater detail below. A large trader must disclose to the U.S.-registered broker-dealers effecting transactions on its behalf its LTID and each account to which it applies, and must also provide promptly such additional descriptive or clarifying information as the SEC requests to assist it in further identifying the large trader and all accounts through which the large trader effects transactions.

**Large Traders in Complex Organizations**

If a natural person or subsidiary entity within a larger organization independently qualifies as a large trader, but the parent company identifies itself to the SEC and broker-dealers as the large trader, the natural person or subsidiary entity would not have to identify itself separately as the large trader or comply with the Rule; the parent company would have the compliance obligation. In focusing on parent companies, the SEC notes that, “to determine whether a parent company is a large trader, the aggregate trading activity of all entities controlled by the parent company must be collected.”\(^9\) That is, even if any individual employee, group or subsidiary entity within a company would not qualify as a large trader, if such employees, groups or subsidiaries acting collectively would qualify as a large trader, \textit{i.e.}, effect transactions that meet or exceed the identifying level threshold, the parent company would be required to identify itself as a large trader. Consequently, for example, a company could not avoid identifying itself as a large trader by allocating its trading among subsidiary entities.

A large trader is relieved from having to comply with the identification and reporting requirements of the Rule if all persons controlled by such large trader that exercise investment discretion with respect to the purchase and sale of NMS Securities collectively comply with all such requirements applicable to such large trader with respect to all of its accounts. Unless all persons exercising investment discretion with respect to the purchase and sale of NMS securities that it controls have identified themselves to the SEC with respect to all accounts of the controlling person, however, a controlling person still is required to comply with the identification and reporting requirements. If, for example, a holding company has two large trader subsidiaries, only one of which elects to file its own Form 13H, the holding company would also have to file its own Form 13H that includes both subsidiaries.

The SEC states that obtaining transaction data at the parent company level, rather than at the level of sub-groups within the organization, “should provide the Commission with important information at a lower cost to the industry, by reducing the complexity and burdens of the large trader reporting requirements ... that could have required reporting at multiple levels within a

\(^8\) Identification and disclosure requirements are set out in paragraph (b) of the Rule.

\(^9\) Adopting Release at 46965.
control group.”

Although large trader reporting focuses on reporting at the parent company level, Item 4(d) of Form 13H permits a large trader to assign LTID suffixes to sub-identify groups under its control. Use of suffixes “could facilitate a large trader’s ability to accurately and efficiently track with more particularity the trading for which it exercises investment discretion, and as a consequence, could facilitate the ability of a large trader to respond to any Commission request to further identify accounts or disaggregate trading data.”

The SEC, moreover, anticipates that a consolidated audit trail, if adopted, “would require collection of information about the person with investment discretion for each order as well as information to identify the beneficial owner for each order.”

“Person,” “Control” and “Investment Discretion” under the Rule

Central to determining who is a large trader for purposes of complying with the Rule are the definitions of “person,” “control” and “investment discretion.” By cross-referencing other provisions of the Exchange Act, the Rule effectively defines “person” to include, among others, a natural person, a company, and two or more persons acting as a partnership, limited partnership, syndicate, or other group, excluding a foreign central bank.

The Rule defines “control” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract or otherwise.” Under this definition, an investment adviser to multiple private funds with separate portfolio managers arguably would control those funds. Furthermore, any person who has (1) the direct or indirect right to vote or direct the voting of 25% or more of a class of an entity’s voting securities, or (2) the power to sell or direct the sale of 25% or more of a class of voting securities of such an entity (or, in the case of a partnership, has the right to receive upon dissolution, or has contributed, 25% or more of the partnership’s capital) is presumed to control the entity.

“Investment discretion” has the meaning set out in Exchange Act Section 3(a)(35), which provides that a person exercises investment discretion with respect to an account if such person, directly or indirectly, (1) may determine what securities or other property is purchased or sold by or for the account, (2) determines what securities or other property is purchased by or for an account even if other persons may have responsibility for investment decisions, or (3) “otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines … should be subject to the operation of the provisions” of the Exchange Act. The SEC notes that an “investment adviser exercises investment discretion over the assets of the investment company” it advises. The SEC specifically declined to adopt suggested exclusions from large trader reporting for registered investment company or pension fund managers.

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10 Adopting Release at 46966.
11 Id. at 46965-46966.
12 Id. at 46966.
13 Control includes “controlling,” “controlled by,” and “under common control with.”
14 Adopting Release at 46965.
15 Id.
Transactions and NMS Securities

The term “transaction” or “transactions” for purposes of determining if a person has effected transactions in NMS securities at or exceeding the identifying level means all transactions in NMS securities, subject to two exceptions. First, purchases and sales of NMS securities pursuant to exercises or assignments of options are excluded, as discussed more fully below. Second, eight types of transactions specified in the Rule are also excluded. Those transactions include: (i) journaling/booking entries to record the receipt or delivery of funds or securities in settling a transaction; (ii) an offering of securities by an issuer, other than an offering effected through the facilities of a national securities exchange; (iii) a gift of securities; (iv) a distribution of securities that are part of a decedent’s estate; (v) a transaction effected pursuant to a court order or judgment; (vi) a rollover of a qualified plan or trust; (vii) an award, allocation, sale, grant or exercise of an NMS security, option or other right to acquire the securities at a pre-determined price pursuant to a compensatory arrangement; and (viii) any transaction to effect a business combination (e.g., a merger or consolidation, among others), an issuer tender offer or other issuer stock buyback, or a stock loan or equity repurchase agreement.16

“NMS security” means “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.”17 The Rule applies to trading in NMS securities effected through any facility of a national securities exchange, in domestic over-the-counter (“OTC”) markets, in foreign OTC markets, or through after-hours systems.

Identifying Activity Level

The Rule requires participants to use a so-called “gross up” approach in calculating activity levels. “Offsetting or netting transactions among or within accounts, even for hedged positions, would be added to a participant’s activity level in order to show the full extent of a trader’s purchase and sale activity.”18 This means that, in addition to aggregating the volume or market value of purchases and sales of NMS securities, including short sales (that is, short sales are not netted against purchases), the market value of transactions in options or on a group or index of equity securities is also aggregated under the Rule. With respect to options, only purchases and sales of the options, not purchases or sales of the underlying securities upon exercise or assignment, are included. This aggregation approach means that if a person purchased, say, 50,000 shares of XYZ stock and 800 XYZ call options, the aggregation provisions would view those purchases as constituting transactions in 130,000 shares of XYZ (50,000 shares purchased +800 option contracts times 100 shares of XYZ per contract).

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16 These transactions are excluded solely for purposes of determining if a person has reached the identifying activity level such that the person qualifies as a large trader. Transactions excluded for such purposes are not excluded from a large trader’s reporting obligations.

17 17 CFR 240.600(b)(46).

18 Adopting Release at 46967 n.63. Aggregation criteria are set out in paragraph (c) of the Rule.
In determining a person's identifying activity level, the SEC stated that “it is appropriate to count transactions effected in the secondary market to assemble, or dispose of, securities that are transferred between an ‘authorized participant’ and an ETF.”\textsuperscript{19} The actual transfer of the basket of securities from the authorized participant to the ETF should not be counted for purposes of large trader reporting, however.

**Form 13H**

Promptly after effecting aggregate transactions equal to or greater than the identifying activity level, a large trader is required to submit to the SEC Form 13H as an “Initial Filing” to identify itself to the SEC and receive its LTID. The SEC believes that “promptly” means that the large trader should make an Initial Filing within 10 days after reaching the identifying activity level.\textsuperscript{20} Form 13H will be filed electronically through the SEC’s EDGAR system.

A large trader has to file an Amended Filing no later than the end of calendar quarter in which any information contained in its Form 13H becomes stale. All large traders are required to submit an “Annual Filing” 45 days after the end of each full calendar year, irrespective of whether any information on the Form 13H has become inaccurate, with the exception of traders on Inactive Status. As set out in the instructions to Form 13H, “Inactive Status” occurs if a large trader meets the criteria for such status (aggregate transactions have not reached the identifying level during the previous full calendar year) and chooses to become inactive by filing Form 13H to request such status. If the person once again became a large trader, it must submit a “Reactivated Status” filing. Finally, a large trader submits a “Termination Filing” to terminate such status permanently (because the trader has ceased operations or merged with, or been acquired by, another entity that has or obtains an LTID). As noted, all Form 13H filings are confidential.

Form 13H requires a large trader to submit substantial information about itself and certain of its affiliates. Item 1(a) to Form 13H requires a large trader to check the box or boxes that best describe its and its affiliates’ businesses, for example, hedge fund, investment adviser or broker-dealer, among others. The large trader also must describe in Item 1(b) the nature of its business and the business of each of its “Securities Affiliates,” including trading strategies.\textsuperscript{21}

Item 2 requires a large trader to state whether it, or any of its Securities Affiliates, files any forms with the SEC and, if so, to identify the types of forms, together with CIK numbers.

Item 3 requires a large trader to identify any of its affiliates: (1) registered with the Commodity Futures Trading Commission (“CFTC”), and (2) regulated by a foreign regulator. If any large trader or affiliate is such an entity, it has to provide additional information, such as a CFTC registration number or the identity of its primary foreign regulator.

\textsuperscript{19} Adopting Release at 46969.

\textsuperscript{20} Id. at 46970.

\textsuperscript{21} Form 13H defines “Securities Affiliate” as “an affiliate of the large trader that exercises investment discretion over NMS securities.”
Item 4 requires the large trader to disclose certain information about the organization of its business, including attaching an organizational chart to its Form 13H filing. The chart has to depict the large trader, its parent company (if applicable), all of its Securities Affiliates and affiliates registered with the CFTC. The large trader has to separately list its Securities Affiliates and affiliates registered with the CFTC and provide certain information about those affiliates, such as market participant identifications, a description of their businesses and their relationship to the large trader. Item 4 also requires the large trader to identify any affiliates that file separately and to list any affiliates that have been assigned LTID suffixes and their suffixes.

Item 5 requires disclosure of information about the governance of the large trader, including its business form (e.g., limited partnership, limited liability company or corporation). The large trader also has to provide the identification of each partner in the large trader’s partnership and its partnership status (general partner or any limited partner that is the owner of more than a ten percent financial interest in the accounts of the large trader). The large trader has to identify its executive officers, directors and trustees, as applicable.

Finally, Item 6 requires a large trader to list all U.S.-registered broker-dealers at which it or its Securities Affiliates have an account. Each such broker-dealer has to be identified as a prime broker, executing broker or clearing broker.

**Broker-Dealer Reporting, Recordkeeping and Monitoring Obligations**

Rule 13h-1 imposes certain recordkeeping requirements on U.S.-registered broker-dealers. The Rule requires a broker-dealer to maintain records of specified information for all transactions effected directly or indirectly through (i) an account that the broker-dealer maintains for a large trader or Unidentified Large Trader, (ii) if the broker-dealer is a large trader, any proprietary or other account over which the broker-dealer exercises investment discretion and (iii) an account carried by a non-broker-dealer for a large trader or an Unidentified Large Trader (that is, under such an arrangement, the broker-dealer effecting transactions directly or indirectly for the large trader or Unidentified Large Trader has the recordkeeping obligation).

The broker-dealer must maintain various categories of information about a large trader’s transactions including, among others: account number, date of execution of transactions, security symbol, transaction price, number of shares or options subject to the transaction, whether the transactions were effected for customers or on a proprietary basis, the identity of the market center where the transaction was executed, time of execution, LTID, prime broker identifier, average price account identifier, and depository account identifier, if applicable. With respect to an Unidentified Large Trader, in addition to the preceding information, the broker-dealer also is required to retain and report such person’s name, address, date the account was opened and tax identification number(s).

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22 An “Unidentified Large Trader” is a person who has not complied with the identification requirements of the Rule and that a broker-dealer knows or has reason to know is a large trader. Rule 13h-1(a)(9).

23 Broker-dealer recordkeeping requirements are set out in paragraph (d) of the Rule.
Information required to be made and kept under the Rule must be available the morning after the day on which transactions in the NMS securities were effected (including Saturdays and holidays).

The Rule requires a U.S.-registered broker-dealer, upon the SEC’s request, to report electronically to the SEC through EBS the information required to be retained with respect to transactions effected directly or indirectly by or for accounts maintained by the broker-dealer for the large trader or Unidentified Large Trader for which information is sought. A broker-dealer has to report only transactions that equal or exceed the reporting level activity. Reporting level activity includes (i) each transaction in NMS securities, effected in a single calendar day, that is at least 100 shares; (ii) any other transactions in NMS securities, effected in a single calendar day, that the broker-dealer deems appropriate; and (iii) other levels that the SEC designates. Reporting level activity is determined on an account-by-account basis, i.e., not aggregated across accounts. 24

The Rule requires a U.S.-registered broker-dealer to treat as an Unidentified Large Trader any person that the broker-dealer “knows or has reason to know” is a large trader 25 and that has not identified itself as such. A broker-dealer therefore has a duty to monitor for Unidentified Large Traders. A broker-dealer would not be deemed to know or have reason to know that a person is an Unidentified Large Trader, however, if, based on its knowledge of its customers and their trading activity, it has no reason to expect that any of these customers’ transactions approached the identifying activity level. 26 Alternatively, the Rule establishes a “safe harbor” with respect to the duty to monitor for Unidentified Large Traders. A broker-dealer can rely on the safe harbor if it (i) does not have actual knowledge that a person is a large trader; and (ii) establishes and maintains policies and procedures reasonably designed to assure compliance with the identification requirements of the safe harbor. The broker-dealer’s monitoring policies and procedures would need to contain systems reasonably designed to inform persons about their obligations under the Rule. 27

Issues and Considerations

The Rule creates difficult choices for organizations in determining which entities within the organization should comply with the requirements of the Rule. The control person (e.g., parent company, investment adviser or other control person) within an organization could comply with the Rule on behalf of all entities that it controls and that exercise investment discretion with respect to the purchase or sale of NMS securities. If the organization chooses to comply with the

24 Reporting requirements are set out in paragraph (e) of the Rule.
25 The SEC states that a broker-dealer does not have “reason to know” that a person is a large trader other than by reference to transactions in the accounts of the broker-dealer. Adopting Release at 46979. “[T]he broker-dealer is not required to proactively make further inquiries for the purpose of determining the customer’s status (e.g., by seeking to determine the customer’s trading activity at other broker-dealers).” Id.
26 Id.
27 The safe harbor requirements are set out in paragraph (f) of the Rule.
Rule at the control person level, data regarding all transactions in NMS securities effected by any controlled persons within the organization would have to be tagged with the LTID and be subject to potential disclosure to the SEC by the broker-dealers maintaining such persons’ securities accounts. For example, the investment adviser to a hedge fund or mutual fund complex could obtain a single LTID for the entire organization. Under this approach, the SEC could obtain from the broker-dealers carrying the accounts of the funds data relating to transactions in NMS securities effected on behalf of all funds within the complex.

Alternatively, each controlled person within an organization that exercises investment discretion with respect to the purchase or sale of NMS securities could separately comply with the Rule. Each such person would obtain its own LTID, and transactions in NMS securities by those persons would be subject to disclosure to the SEC. Compliance with this alternative, however, could be more burdensome as compared to compliance with the Rule at the control person level. The organization would have multiple LTIDs and multiple Form 13H filing requirements. The organization would need to implement policies and supervisory procedures to ensure compliance with the Rule among multiple persons.

The language of both the Rule and the Adopting Release is unclear as to which entities within a large organization must comply with the Rule if the organization chooses to comply with the Rule at the controlled person level, rather than at the parent company level. The Rule and the discussion in the Adopting Release on this issue arguably require any controlled person within the organization that exercises discretion with respect to transactions in NMS securities to comply with the Rule, irrespective of whether that entity itself qualifies as a large trader. This reading of the Rule would result in entities that do not qualify as large traders nevertheless being required to identify themselves as such to the SEC, obtain an LTID and make any necessary Form 13H filings. The SEC needs to clarify whether this is its intent, or whether only those controlled entities within an organization that separately qualify as large traders are subject to complying with the Rule if the organization chooses not to comply with the Rule at the parent level.

The Rule does not permit the control person to comply with the Rule only on behalf of certain controlled persons within the organization that exercise discretion with respect to the purchase and sale of NMS securities, while allowing other such controlled persons to comply with the Rule independently. It is not clear what policy purpose this regulatory approach serves.

A U.S.-registered broker-dealer could have two distinct sets of compliance obligations under the Rule. First, if it maintained securities accounts for large traders, it would have recordkeeping, reporting and monitoring obligations under the Rule with respect to transactions in NMS securities effected through those accounts, as discussed above. It would need to develop policies and supervisory procedures with respect to such obligations. Second, the broker-dealer might itself qualify as a large trader (e.g., based on its proprietary trading) and, thus, need to comply with the obligations imposed on large traders under the Rule (e.g., it would need to obtain an LTID and file Form 13H), and develop separate policies and supervisory procedures with respect to its status as a large trader. A broker-dealer that engaged in proprietary trading would be a large trader if it reached identifying activity levels. What is less clear is whether a broker-dealer’s activities could trigger large trader status under other circumstances. For example, a
floor broker acting as agent may determine when to place in and sell securities out of an error account arising from error transactions involving a customer’s order. In doing so, it could be viewed as exercising investment discretion within the meaning of the Rule. Although it does not appear that the Rule was meant to apply in such circumstances, the SEC or its staff should provide guidance on the application of the Rule in this and any other similar circumstances.

The Adopting Release also does not address what role, if any, self-regulatory organizations ("SROs") may play with respect to the Rule. The SEC is entitled to request data from broker-dealers on large traders under the Rule, subject to keeping such information confidential. It is not clear if that confidentiality obligation means that the SEC intends to share large trader data with SROs if the SROs request such data for purposes of performing their market surveillance obligations. As a practical matter, however, the SROs may be able to obtain large trader data from broker-dealers under their authority to review the books and records of the broker-dealers that they supervise.

Persons are permitted to voluntarily identify themselves as large traders by filing Form 13H and obtaining an LTID. Persons who believe they might become subject to the Rule by virtue of their trading activity in NMS securities might wish to consider voluntary identification in order to give themselves sufficient time to develop appropriate internal systems to comply with the Rule.

If you have any questions regarding this memorandum, please contact Roger D. Blanc (212-728-8206, rblanc@willkie.com), Daniel Schloendorn (212-728-8265, dschloendorn@willkie.com), Howard L. Kramer (202-303-1208, hkramer@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), Matthew B. Comstock (202-303-1257, mcomstock@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, DC telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

August 4, 2011

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